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April 26, 2005

Memorandum

To: Honorable John Morgan, Comptroller of the Treasury

Honorable David Goetz, Commissioner of Finance and Administration

Honorable Dale Sims, Treasurer

Honorable Riley Darnell, Secretary of State

From: Kevin Krushenski, Senior Legislative Research Analyst

Date: 4/26/2005

Re: Economic Report to the Governor

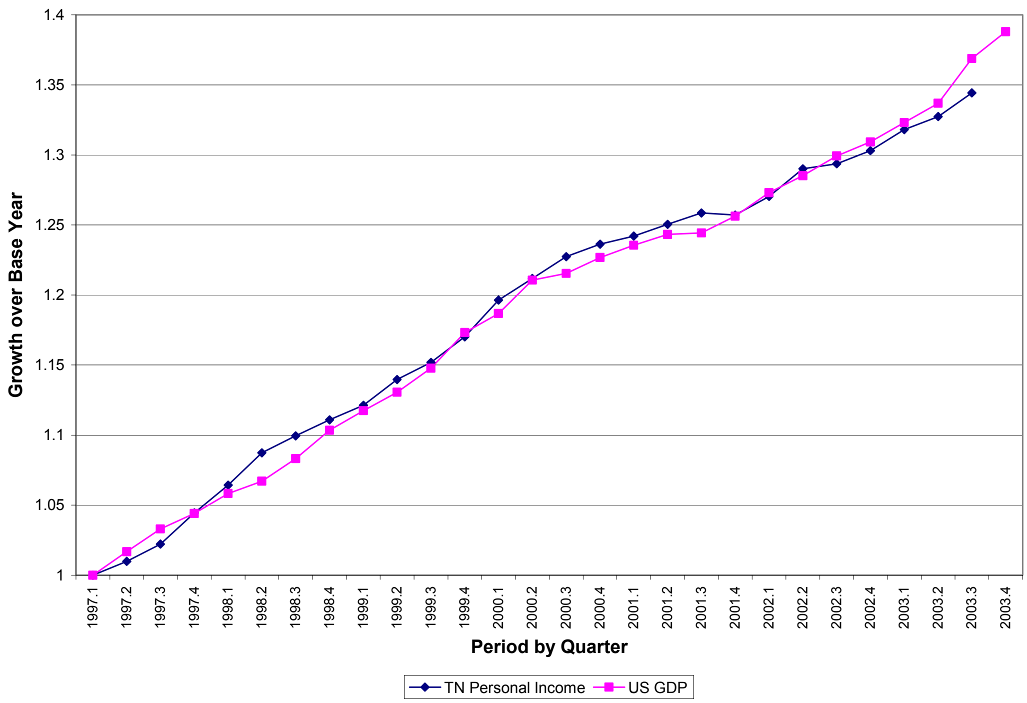
As required by TCA §9-4-5202, the State Funding Board (the Board) shall secure estimates of economic growth from the Tennessee econometric model published by The University of Tennessee's Center for Business and Economic Research (CBER) in its annual *Economic Report to the Governor* each year. The Report provides an overview of the current estimates of economic growth statistics, such as nominal personal income growth and employment growth. TCA §9-4-5202 also prescribes the Board to comment on the "reasonableness" of CBER's estimate of nominal personal income growth in Tennessee. The Comptroller's Office of Research assists the Board by evaluating current economic conditions and trends via outside forecasts.

Overall Conclusion: Based upon a review of various economic forecasts and other trends in the world economy, CBER's projections of 5.5 percent nominal personal income growth for 2005 appear reasonable.

Forecast Comparisons

Historically, growth in Tennessee personal income has closely followed growth in United States gross domestic product (GDP). Exhibit 1 shows the relationship between relative growth in Tennessee personal income as it compares to the relative growth in U.S. GDP.

Exhibit 1: Relative Growth of Selected Economic Indicators



Source: United States Bureau of Economic Analysis, www.bea.gov, accessed 4/13/04

Because the relationship between the indicators is very close, for the purposes of this commentary we will compare the GDP estimates produced by CBER with the estimates produced by other economic forecasting agencies.

The U.S. economy experienced moderate real GDP growth in 2004 that is expected to continue throughout 2005. As Exhibit 2 shows, on average, economists forecast 3.7 percent real GDP growth for the U.S., which is only slightly higher than CBER's forecast of 3.6 percent. As was the trend last year, more pronounced growth is expected during the first two quarters of 2005 and many forecasters revised their first two quarters estimates upward.[1] This early growth will be seen in all sectors of the economy, except the trade sector, but may be impacted over the course of the year by high energy prices, the trade deficit, and interest rate increases.[2] These economic occurrences and other possible macroeconomic contributions will be discussed later in the commentary.

Exhibit 2: Forecast Comparison: 2005 Real GDP Growth

Agency	Rate	Forecast Date
Fannie Mae	3.9%	Apr-05
Wachovia	3.7%	Mar-05
Philadelphia FBR	3.6%	Feb-05
Northern Trust	3.7%	Mar-05
CBER	**3.6%**	**Jan-05**
Forecast Average	3.7%	

Source: Fannie Mae, Wachovia, Federal Reserve Bank of Philadelphia, and Northern Trust

Potential Macroeconomic Influences

Job Growth and Unemployment

A major economic concern remains the continued modest pace of job growth. Many economists are projecting job gains in many sectors. In the most recent release of the employment data, non-farm payroll employment only increased by 110,000 in March, but the unemployment rate has dipped to 5.2 percent.[3] Exhibit 3 at the right shows the erratic growth in U.S. payrolls. In March of 2005, 72 percent of CEOs participating in the Business Roundtable's CEO Economic Outlook Survey projected that employment will either remain the same or increase in the next six months. This percent is fewer than the percent of CEO's who responded last year. Other forecasters have revised their estimates for job gains in 2005 downward from previous estimates.[4] Of course, certain macroeconomic changes may impact this projected job growth.

Exhibit #3

Source: "Job Growth Disappoints" CNN Money, April 1, 2005

[1] "Survey of Professional Forecasters", The Federal Reserve Bank of Philadelphia, Economic Research, February 14, 2005

[2] Berson, David W. aand Orawin Velz, Fannie Mae Economists, "Economic & Mortgage Developments," p.2

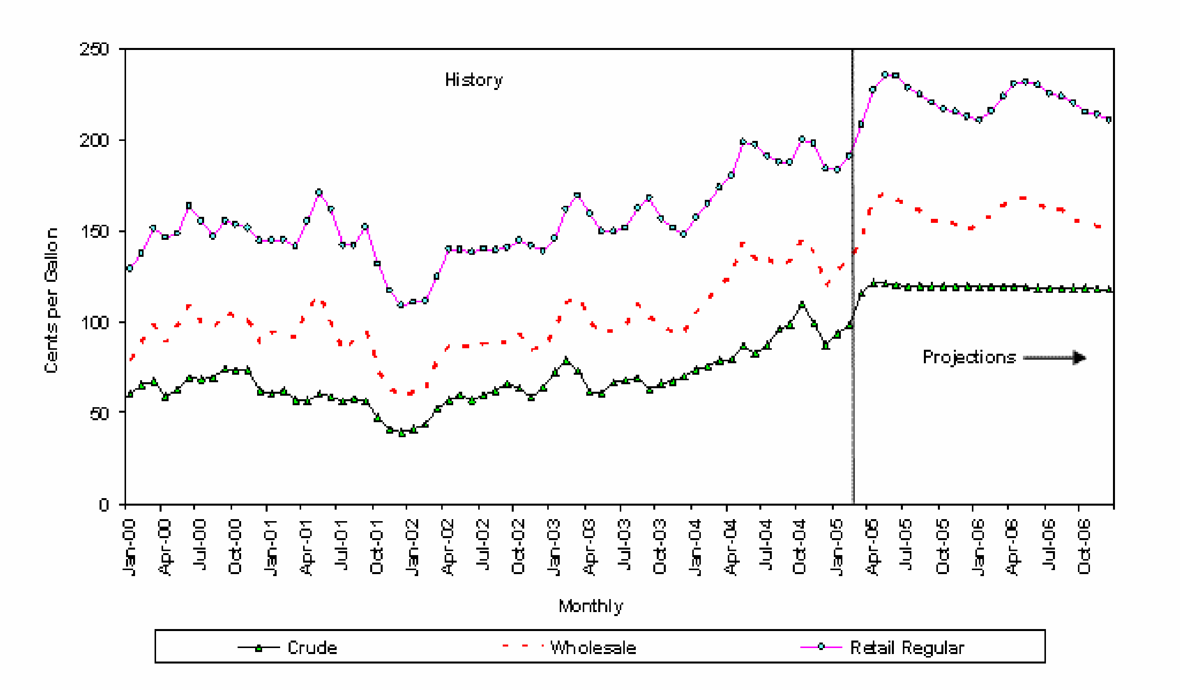
[3] U.S. Department of Labor, Bureau of Labor Statistics, "Employment Situation Summary," April 1, 2005

[4] "Survey of Professional Forecasters", The Federal Reserve Bank of Philadelphia, Economic Research, February 14, 2005

Oil Prices

Oil prices continued to be affected by supply and demand issues and other international political matters. Continued instability of post-war Iraq and OPEC's inability to meet rising demands for oil around the world are driving oil price inflation. Concurrent with oil price increases, retail gas prices increased and are expected to continue this trend. As Exhibit 4 shows, this trend in oil and retail gasoline prices is not expected to subside anytime soon with projections higher than current levels.

Exhibit 4: Gasoline Prices and Crude Oil Costs



Source: U.S. Department of Energy, Energy Information Administration, Short Term Energy Outlook, April 2005

Many economists agree that if oil prices are sustained at current levels there could be negative macroeconomic ramifications. Recent surveys of business and consumer sentiment have edged down over the past couple of months, which could be attributed to higher oil prices.[5] Caution should be advised in the near term as these higher oil and gas prices may lead to less growth in inflation adjusted outlays.[6] As Exhibit 4 shows above, the Energy Information Administration (EIA) anticipates summer gas prices to top out near an all time high of $2.50 in nominal prices. Oil and gas price shocks such as these have a direct effect on economic growth since rising oil prices mean reduced supply of oil which is an important input to business production.[7] While these oil and gas price shocks have not and are not expected to achieve all-time real price highs, any additional shocks to oil and gas prices could severely hamper economic and business growth.

[5] Berson, David W. aand Orawin Velz, Fannie Mae Economists, "Economic & Mortgage Developments," p.3

[6] Wachovia Economics Group, "Monthly Economic Outlook," April 11, 2005.

[7] Stephen P.A. Brown, et al, "Business Cycles: The Role of Energy Prices," Working Paper 03-04, Federal Reserve Bank of Dallas – Research Department, 2003, p. 2

Business Investment

Most economists expect business investment to pick up this year through increasing capital spending. The fed has raised interest rates over the past year and is expected to continue to do so. These increases are not expected to be large, however.[8] The CEO Economic Outlook Survey found 60 percent of CEOs anticipate increasing capital spending this year.[9] The low value of the dollar continues to impact the economic outlook and may eventually make U.S. exports more attractive in foreign nations. The current trade balance deficit reached $61 billion in February and has been above $50 billion since June of 2004. Retail sales rose 0.3 percent in March, which was well below the 0.8 percent increase economists planned for.[10] The combination of these two observations does create cause for concern as foreigners could become reluctant to hold U.S. dollar assets and may send interest rates even higher.

Summary

The economy appears poised to continue the moderate growth level seen toward the tail end of last year. The continual problems of sustained high oil prices, along with the potential inflation concerns, may impede potential growth, but most economists would not project those impediments to be too severe. Based upon this research, the CBER estimates of 5.5 percent growth in nominal personal income for 2005 appear reasonable.

[8] Berson, David W. aand Orawin Velz, Fannie Mae Economists, “Economic & Mortgage Developments,” p.3

[9] “CEO Economic Outlook Index Marks New High as Companies Predict Continued Solid Growth,” March CEO Economic Outlook Survey Results, www.businessroundtable.org

[10] “Retail sales softness in March,” http://money.cnn.com, April 13, 2005